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January 28, 1988

MEMORANDUM

TO: The Trade Policy Review Group

FROM: The TPSC Subcommittee on Mexico

SUBJECT: U.S.-Mexico Trade Relations

ISSUE

The President has requested an examination of the prospects for establishing a special trade and investment relationship with Mexico. He has similarly requested an examination of trade and investment issues that affect the U.S.-Mexico border. In preparation for an examination of these questions, the TPSC Subcommittee on Mexico has provided below possible options for TPRG consideration.

RECENT DEVELOPMENTS IN U.S.-MEXICO TRADE RELATIONS

Mexico is the fourth largest trading partner of the U.S. Total trade between the two countries in 1987 will approach $35 billion. Mexico, which is our third largest supplier of crude oil, has also seen its manufactured exports grow at between 35 and 40 percent in 1986 and 1987.

Mexican trade policy has undergone an important evolution during the De la Madrid Administration. To move Mexico away from economic development based on import substitution and oil export earnings, the De la Madrid Administration has stimulated the process of structural adjustment through a reduction in domestic subsidies and an opening of the domestic market to import competition. With respect to trade, substantial liberalization has taken place in the level of tariffs and in the use of import licenses and official reference prices: the three tools used by Mexico in the post WWII period to control imports.

At the end of 1983, all of the more than 8300 Mexican tariff categories were subject to import licensing requirements; now only 329 categories (mainly covering the auto and pharmaceutical sectors, some agricultural products, drugs, firearms, and some luxury items) are still covered. Official reference prices, which covered over 1500 tariff categories two years ago, were totally eliminated at the end of 1987. Tariffs were as high as 100 percent as recently as April 1986, but have been reduced to a maximum applied rate of 20 percent as of December 15, 1987. The 5 percent general import tax, applied on top of the normal duty, was eliminated on December 15, 1987. The average weighted Mexican tariff is now 5.6 percent.

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Mexico has complemented these measures by acceding to the GATT on August 24, 1986, and by signing on November 6, 1987, with the U.S. a bilateral framework agreement for trade and investment. The significant reduction in Mexican licensing requirements and the elimination of official reference prices have fulfilled commitments made by Mexico during its GATT accession negotiation. However, the tariff reductions implemented by Mexico go well beyond Mexico's GATT commitments.

The framework agreement was an important psychological step forward for Mexico. Its primary result was the establishment of a consultative mechanism which can be invoked by either side at any time to clarify respective trade policies, resolve specific disputes, or negotiate the removal or reduction of trade and investment barriers. Indeed, the two governments formalized an agreement under the framework agreement in late December which provided Mexico a 12.4 percent increase in its 1988 steel quotas in return for adding three wire products to quota restraints, elimination of the Mexican beer, wine and distilled spirits quotas, and elimination of the import licensing requirement on 38 tariff categories.

The U.S. market, is, with a few important exceptions, open to imports from Mexico. Over 80 percent of Mexican exports to the U.S. enter at a duty rate between 0 and 5 percent. There are no section 301 measures against Mexico, while quotas on stainless steel imports are the only section 201 measures affecting Mexico. (These quotas have, in practice, not proven particularly restrictive for Mexico.) Mexico is now the fourth largest beneficiary of the U.S. GSP program, entering over $1.5 billion of products into the U.S. duty free under the program's provisions. The steel and textile quotas have recently been increased, and the meat embargo is under technical review. The embargo on fresh avocados appears to be technically justified because of seed weevil infestation in Mexico. The sugar quota has had little impact since Mexico consumes almost all its sugar production domestically.

On the whole, the U.S. and Mexico are now enjoying good and cooperative trade relations. The substantial trade liberalization in Mexico since July 1985, much of it unilaterally implemented for Mexico's own economic development, has reduced or eliminated many of the longstanding bilateral trade irritants with respect to market access. In fact, the amount of trade liberalization has gone beyond what any observer expected. Mexico's GATT accession negotiation, the GSP General Review, and the framework agreement have moved the focus of the trade relationship away from any concessionary approach by the U.S. to a mutually accepted approach of reciprocity. The recent steel/beer/wine/distilled spirits agreement and even the new textile agreement reflect this. Mexican foreign investment policy and certain intellectual property issues are now the major difficulties in the bilateral trade and investment relationship.

I. OPTIONS FOR A SPECIAL TRADE RELATIONSHIP

A special trade relationship with Mexico could be structured in three ways:

1) build upon the recently signed framework agreement;

2) grant unilateral market access concessions, such as by designating Mexico as a CBI beneficiary country; or

3) seek to negotiate a free trade arrangement.

1) Framework Agreement for Trade and Investment: This recently-signed agreement already provides a new structure for managing bilateral trade and investment relations. By providing for possible consultation on any trade or investment issue, this executive agreement complements and strengthens the obligations we have to one another as GATT members. This agreement itself is acknowledgement of a special bilateral trade and investment relationship. The recent steel/beer/wine/distilled spirits agreement is an example of the productive options which exist with this mechanism. In late February, the two governments will commence in-depth discussions on Mexican policy towards foreign investment, Mexican intellectual property protection, Mexican computer sector development plans, exchange of trade data, and the status of the bilateral subsidies understanding. With respect to investment and IPR, the most the U.S. can do at this late stage in De la Madrid's Administration is put down fresh markers on U.S. concerns, argue that improvements in these area are in Mexico's own self-interest, and urge Mexico to make as many minor administrative improvements as possible in the administration's final months.

2) CBI Treatment for Mexico: This is an issue that arises periodically. The TPSC Subcommittee on Mexico believes that granting such status to Mexico would seriously undermine the President's intent of promoting the economic development of the Caribbean basin. There is a general belief that Mexico would prove a much stronger magnet for foreign investors than would the current CBI beneficiaries. In addition, CBI status, which would permit duty-free entry into the U.S. of most Mexican exports, would eliminate whatever leverage the U.S. might have in seeking changes in Mexican investment or trade policy. CBI status would involve concessions by the U.S. for Mexico, with no improvements in access for U.S. exports or investors to Mexico. Also, the President would need to obtain legislative approval before designating Mexico.

3) Free Trade Arrangement: The framework agreement would provide the forum for conducting a bilateral FTA should this goal be eventually endorsed by both countries. However, any discussion of an FTA at this time would be totally counterproductive. President De la Madrid and Hector Hernandez (Secretary of Commerce and Industrial Development) have gone to great lengths since the

signing of the framework agreement to assure the Mexican population that the GOM does not intend to even consider an FTA with the U.S. anytime soon. Any mention of the issue by the U.S. simply encourages opponents of trade liberalization in general to question publicly the true intentions of the De la Madrid Administration. The TPSC Subcommittee on Mexico believes that Mexico must both digest the trade liberalization undertaken by De la Madrid and lessen the current degree of disparity in economic development levels before the two sides could consider an FTA. While the TPSC Subcommittee on Mexico strongly endorses the need for stimulating two-way trade, it is questionable whether the U.S. Congress and private sector, particularly the unions, would endorse such a position given their fears that the lower wage rate in Mexico would lead to a flood of imports and Mexico's inability at this time to move on investment. In addition, any mention of a possible FTA with Mexico at this time could jeopardize congressional approval of the U.S. - Canada FTA.

RECOMMENDATION OF TPSC SUBCOMMITTEE ON MEXICO:

That the U.S utilize the framework agreement as the means for improving the bilateral trade and investment relationship. The recent steel/beer etc. agreement is concrete evidence of how the agreement can be used to address specific problems and remove barriers to trade. The Subcommittee believes an FTA negotiation is premature economically and politically for Mexico, and probably also for the U.S., but notes that the trade reforms being implemented by Mexico now are the very steps that could eventually make an FTA possible.

II. OPTIONS FOR SPECIAL TRADE MEASURES

1. Partial CBI Treatment: Mexico exports a broader range of products than do the CBI countries. It might be possible to extend duty-free treatment on a list of products for which the CBI countries are small or non-suppliers. This would require Congressional approval. Another possibility is to provide CBI treatment on textiles only. A major complaint of the GOM and certain U.S. Senators and Representatives from the border states has been the charging of the full value of the U.S. content of 807 textile imports from Mexico against the Mexican textile quotas. Political considerations have largely kept the Administration from excluding totally such trade from the quotas. However, the new bilateral textile agreement partially addresses the problem by establishing new quotas for 807 trade only; that is, quotas reserved for U.S. cut and formed material.

2. Improve Mexico's GSP Benefits

In an effort to further improve on Mexico's use of the GSP program, the TPRG could recommend that USTR quietly express to the GOM a willingness to consult on methods to potentially further increase Mexico's use of the GSP program. This could be accomplished through the existing GSP Annual Review process as

well as, if appropriate, offering to provide GSP technical assistance seminars to the Mexican private sector and appropriate GOM officials. The willingness to work with the GOM on methods to potentially improve their use of the GSP program (for example, the possible granting of unlimited duty-free access to the U.S. on selected products through "competitive need waivers" in the context of Annual Review process) would be predicated on the Mexican's willingness to be responsible to U.S. country practice concerns. Any initiative of this type would have to be a government to government confidential understanding in order to avoid complicating our bilateral relationship with other beneficiaries. In addition, if this initiative were to become public knowledge, it would greatly complicate our ability to continue to administer the GSP program in an equitable manner vis-a-vis the private sector and, thus, could raise concerns in Congress. One point to keep in mind is that the removal of the Asian beneficiaries from the U.S. GSP should help Mexico.

3. <u>Negotiate an additional steel deal</u>

On December 29, 1987, the U.S. and Mexico formalized an agreement which provided a 12.4% increase (equal to 0.03% of U.S. apparent consumption) in Mexico's 1988 steel quotas in return for adding certain wire products to the steel arrangement and for significant market access improvements in Mexico (i.e., elimination of Mexican import quotas and licensing requirements on beer, wine and distilled spirits and elimination of import licensing requirements on 33 other tariff categories). Due to certain product shortages in the U.S. market and a Mexican interest in increasing its steel exports, USTR could consider offering to increase further Mexico's steel quotas in return for market access, trucking services, or foreign investment regulation concessions.

4. <u>Credit for Trade Liberalization Undertaken as part of World Bank Structural Adjustment Loans</u>

Another step towards trade liberalization could be achieved through a tariff and non-tariff barrier negotiation in which, Mexico would bind trade concessions made as part of two recent World Bank structural adjustment loans in return for U.S. concessions.

The idea of a "trade credit" has considerable support from the World Bank including the Development Committee and President Barber Conable. Although there has been no detailed discussion as to the specific conditions under which these concessions would be negotiated, the concept is under study by the Uruguay Round Working Group on Developing Countries. A practical precedent exists in the U.S.-Philippine Section 124 Negotiations held in 1981. At the suggestion of the World Bank, the Philippines approached the United States asking for trade negotiations in which they would bind tariff cuts and licensing changes made as part of a structural adjustment loan in return for U.S. tariff cuts made with residual authority left over from the Tokyo Round.

The negotiation was not completed before U.S. tariff authority ran out.

In the case of Mexico, there are two structural adjustment loans worth $1 billion that are already being disbursed. As part of the loans, Mexico pledges to remove items from their licensing list and reduce tariffs to 30 percent MFN on $40 million in trade. These concessions are technically only good for the life of the loan and can be easily reversed after that. To create permanent change in the trading system, Mexico would have to bind these cuts in the GATT on an MFN basis. Mexican quantitative restrictions could be removed and converted to GATT-bound tariffs as part of the negotiations.

On the U.S. side, we would need tariff negotiating authority for the exercise. The Congress might be willing to entertain this request as part of the Trade Bill, particularly if Senator Bentsen could be interested in sponsoring this legislation. The overall advantage of this proposal is that it would ensure permanent trade liberalization as well as set a precedent for U.S.-LDC negotiations in the Uruguay Round.

III <u>OPTIONS ON SPECIAL INVESTMENT RELATIONSHIP</u>

The U.S. is by far the largest source of foreign investment in Mexico. Total U.S. direct investment in Mexico is $5.9 billion (1986 estimate), or 68.2% (1985) of all foreign investment in Mexico. This $5.9 billion represents only 2.5% of total U.S. foreign investment, with Mexico ranked 12th among countries receiving U.S. foreign investment (but 2nd among LDCs).

In most cases foreign investment is limited to 49 percent of equity, although majority ownership can be negotiated with the Foreign Investment Commission. In those latter cases, majority ownership is authorized only in return for commitments on local content, export performance, location, and R and D requirements. In addition to these general rules regarding foreign investment, Mexico has developed sectoral programs in automobiles, electronics and pharmaceuticals. In each case, all investment approvals are dependent upon commitments for local content, technology transfers, export performance and net foreign exchange earnings. These restraints on foreign investors are now, in light of the significant progress made in the last two years on market access issues, the single largest area of disagreement in our bilateral trade and investment relations. We believe these obstacles to investment are not just irritants to the U.S., but counterproductive to Mexico's own economic development.

Improvements in Mexican regulation of foreign investment would make a positive contribution to our evolving economic relationship. On February 22-23, the U.S. and Mexico will hold bilateral discussions on this issue under the framework agreement. Since the De la Madrid Administration is now in its final year, we do not believe that it is in any position politically to adopt

fundamental changes in Mexico's foreign investment law in the near term. However, within the framework agreement we intend to present our concerns regarding the broad scope of Mexican foreign investment policies and press for a few modest improvements in the near term. The more fundamental concerns we raise at this time would be pursued once the new administration is in place. The TPSC Subcommittee on Mexico recommends that we continue to use the framework agreement at this time as the mechanism for seeking improvements in Mexico's investment regime.

The U.S. investment market is essentially open to investment from all sources, including Mexico. Exceptions relate to security concerns which would be inappropriate to modify for Mexico, especially in the absence of major modifications in Mexican policies.

As for an OPIC agreement, the U.S. has tried unsuccessfully on and off since the early 1970s to negotiate such an agreement with Mexico. The most recent bilateral discussions were held in December 1987, with Mexican officials expressing firm interest in such an agreement if enough political support can be generated in the Mexican private sector to overcome Mexico's adherence to the Calvo Doctrine, embodied in Article 3 of Mexico's Foreign Investment Law. This doctrine, common throughout Latin America, basically prohibits investor from seeking diplomatic espousal by his own government of any claim he might have against the host government. Thus, by investing in Mexico, a foreign investor can only rely on Mexican courts to adjudicate any claims. Nonetheless, we should continue to encourage Mexico to reach an OPIC agreement as a positive signal to foreign investment. Discussions will resume in late February in Mexico.

IV <u>OPTIONS ON BORDER RELATIONSHIP</u>

At a recent meeting of the Border Trade Alliance (composed of chambers of commerce and economic development foundations from Brownsville to San Diego), the group listed three main areas in which they would like assistance from the U.S. Administration:

1. <u>Improve infrastructure and customs operations</u>. The complaints are directed at the need for more bridges, more customs crossing points, more customs officers assigned to commercial clearance, improved physical facilities for customs, and a better balance between the drug enforcement and commercial clearance responsibilities of customs.

2. <u>806.30/807.00</u>. Border interests are worried about congressional attempts to modify or eliminate these tariff provisions. They seek a reaffirmation of Administration opposition to any changes in these provisions.

3. <u>Access to the Mexican trucking market</u>. They seek the right for U.S. truck cabs and drivers to operate in Mexico. One possibility might be to offer the GOM increased steel quotas in return for this services concession.

The TPSC Subcommittee on Mexico recommends that the Administration not address the 806.30/807.00 issue until a thorough analysis of the ITC study on those tariff provisions (to be released on January 27) can be completed. Up until now, the administration has opposed the modification or elimination of these provisions. In addition, the Subcommittee suggests that the Transportation Working Group on Mexico (DOT and USTR co-chair) consider addressing the trucking issue under the bilateral framework agreement.

V TRADE OPTIONS FOR THE MEETING OF THE PRESIDENTS

In bilateral trade meetings, Mexican officials usually list the following items as their primary concerns: 1) omnibus trade bill, 2) health of U.S. economy, 3) oil import fee, 4) superfund tax, 5) steel quota levels, 6) treatment of 807 textile imports vis-a-vis Mexican textile quotas, 7) old CVD cases for which Mexico received no injury test, and 8) extension of GSP benefits. In his meeting with De la Madrid, President Reagan could certainly make positive comments about the Administration position on issues 1-3.

The Presidents can sign the new textile agreement if the legal texts are ready.

Finally, particular attention should be drawn to the Framework Agreement which was signed by Mexico and the U.S. in November 1987. The signing of the Framework Agreement fulfilled the Presidents' August 1986 pledge to dedicate their administrations to strengthening trade and investment ties between the two countries. To reinforce the commitment of both nations to continuing progress in that regard, we recommend that the Presidents express their continuing commitment to progressively reduce barriers to bilateral trade and investment, using the Framework Agreement and the GATT process as mechanisms for achieving this.

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